

The Illusion of Scale in Startups: An Analysis of Growth, Funding, and Long-Term Sustainability in Modern Businesses.

Abstract:

The modern startup ecosystem is often characterized by an obsessive need to scale. Whether it is attaining venture capital funding, unicorn valuations, or building hypergrowth narratives in dominating business media, all these actions aim to create the impression that building fast and spending faster is the natural road to success.

This paper examines the gap between the appearance of scale and the reality of sustainable business building. It draws on academic literature, industry data, and case studies and argues that rapid scaling has produced a chain of fragile companies that are not backed by organic customer acquisition and growth.

It also covers the mechanics of startup funding, the economics of artificial growth, the psychological pressures of founder culture, platform dependency risks, and the conditions under which scaling genuinely creates value instead of destroying it.

15 **1. Introduction**

16 **1.1 Background**

17 There is something almost absurd about modern startup stories. A founder has an idea, raises
18 money from venture capitalists who believe in their vision, grows the company at
19 extraordinary speed, and eventually either takes it public or sells it for hundreds of millions of
20 dollars. This narrative is repeated so often, across so many podcasts, business school case
21 studies, and magazine profiles, that it has started to feel like the natural lifecycle of a business
22 instead of an actual exceptional outcome happening to a very small number of companies.

23 According to the Bureau of Labor Statistics (2021), approximately 20% of new businesses
24 fail within their first year, and roughly 45% do not survive past five years. Among venture-
25 backed startups specifically, the failure rate is even more striking. More than 65% of these
26 fail to return even the capital invested in them (Correlation Ventures, 2015).

27 These are not fringe companies with weak ideas since any of them raised tens or hundreds of
28 millions of dollars from investors and operated with teams of talented people. The problem,
29 in many cases, was not the idea, rather, it was the model of growth they were pressured to
30 pursue.

31 **1.2 The Problem with Scale as a Goal**

32 Scaling is one of the most powerful value creation mechanisms in business. A product that
33 costs the same to produce whether it reaches one customer or one million, a platform that
34 becomes more useful as more people join it, a distribution network that gets cheaper per unit
35 as it grows. These are real economic advantages that reward growth.

36 It can be argued that the problem is that scale has become a goal in itself rather than a
37 consequence of genuine competitive advantage. Startups raise money to grow fast, grow fast
38 to justify raising more money, and raise more money to sustain a growth rate that the
39 underlying business economics do not support. At some point, someone has to reckon with
40 whether the business actually works without the capital additions sustaining it.

41 This paper looks at the mechanics of the funding cycle, the economics of artificial growth
42 through customer acquisition spending, the role of narrative in inflating valuations, the
43 challenges that arise when companies scale without operational foundations, and the
44 conditions under which sustainable scaling is actually possible.

45 The illusion of scale is one of the most costly elements in modern business, producing
46 billions of dollars of destroyed capital, significant human costs for founders and employees,
47 and a cultural framework that misrepresents what building a good business actually requires.

48 **1.3 Research Questions and Scope**

This paper addresses three related questions. Firstly, what are the mechanisms through which startups create the appearance of scale without the substance of it? Secondly, what structures and incentives in the VC ecosystem encourage this behaviour? Thirdly, what does genuine, sustainable scaling look like and what conditions are required for it to succeed?

The paper draws on academic literature in finance, organisational behaviour, and entrepreneurship, as well as industry data and case studies from several startup failures and successes.

2. The Mechanics of Startup Funding

2.1 How Venture Capital Actually Works

Before understanding the illusion of scale, it will help to understand the economic logic of venture capital because it explains why investors fund companies that are losing money at extraordinary rates and why founders accept terms that prioritise growth over sustainability.

Venture capital funds operate on a portfolio model as they invest in a large number of companies knowing that most will fail, expecting that the exceptional returns from a small number of winners will more than compensate for all the losses. This is described as a power law distribution of returns. Here, the top two or three investments in a fund generate the majority of its total returns (Metrick and Yasuda, 2010).

This model has a specific implication for how venture capitalists evaluate and support portfolio companies. Because the fund's returns depend on a few exceptional outcomes, investors are incentivised to push companies toward high-growth, high-risk strategies rather than moderate-growth and sustainable ones.

A company that grows at 20% per year and becomes reliably profitable is not particularly useful to a venture fund. Instead, a company that grows at 200% per year and might become worth fifty times the investment, even if it might equally go to zero is exactly what the model seeks. This results in a huge pressure on founders to pursue scale at a pace that their business fundamentals may not be able to support (Gompers and Lerner, 2001).

The funding cycle reinforces this pressure from the inside. Each funding round is priced based on the growth rate and the narrative of the company at that moment. A company that has grown fast enough to justify a high valuation at Series A must grow at least as fast to justify an even higher valuation at Series B.

In these cases, slowing down is considered the same as failure. This creates an environment in which the company must keep accelerating to maintain the credibility of its previous valuation, regardless of whether the underlying economics of the business are improving (Haber, 2022).

2.2 Valuations and the Role of Narrative

Startup valuations are different from valuations in almost any other asset class. A company with no revenue can be worth hundreds of millions of dollars, and a company losing money at accelerating rates can be worth more than profitable companies many times its size. This is not irrational exuberance, though that does play a role.

Rather, it reflects a genuine feature of early-stage technology companies. Their present economics are a poor guide to their future potential if the growth thesis is correct. The question is how often the thesis is correct, and how the valuation process accounts for the cases where it is not.

The role of narrative in asset pricing argues that stories about the future spread through investor communities in ways that produce sustained mispricing (Shiller, 2015). In the startup context, this means that a compelling growth narrative, told persuasively by a charismatic founder with strong early metrics, can attract capital at valuations that assume the best-case scenario is the base. When the narrative is eventually tested against reality, the gap between assumed and actual growth produces the valuation corrections that have periodically swept through the venture ecosystem.

The WeWork case is the most dramatic recent illustration. SoftBank's Vision Fund valued WeWork at \$47 billion in 2019 based on a growth narrative that framed a real estate company as a technology platform. When WeWork attempted to go public and independent analysts were able to scrutinise the financials, the valuation collapsed to below \$8 billion within weeks.

The business had not changed, the narrative had just been subjected to a level of scrutiny that it had not faced before (Brown, 2021). WeWork was exceptional in the scale of its collapse, but the underlying dynamic was not unusual, it was the same growth-narrative-valuation cycle operating at an extreme.

2.3 The ZIRP Era and Its Consequences

It is extremely important to address the role of the near-zero interest rate environment that prevailed between 2009 and 2022. When interest rates are very low, the returns available on safe assets like government bonds are minimal, which pushes investors toward riskier asset classes in search of yield. This dynamic, combined with the successes of companies like Facebook, Uber, and Airbnb during this period, produced an unprecedented flood of capital into venture markets.

The availability of cheap capital during this period changed the behaviour of both investors and founders (Lerner and Nanda, 2020). With abundant money, the cost of pursuing a failed growth strategy was lower, because there was always more capital available to sustain the company through the next round.

Founders raised more than they needed, spent faster than was necessary, and set cost structures that were only defensible if growth continued indefinitely. When interest rates rose

in 2022 and 2023, the cost of capital also increased. This meant that many companies that had been built on the assumption of unlimited cheap capital found themselves unable to raise at their previous valuations or, sometimes, at all.

3. Artificial Growth and the Economics of Customer Acquisition

3.1 Buying Growth: The CAC Problem

One of the most common mechanisms through which startups create the appearance of scale without actual competitive advantage is aggressive customer acquisition spending. The logic behind this is straightforward because if you spend enough on marketing and incentives, you can acquire a large number of customers quickly.

The problem is that acquired customers are not the same as organically attracted customers. They are often less engaged, less loyal, and more likely to leave when the incentives stop. If the cost of acquiring a customer exceeds the lifetime value that customer generates for the business, every customer acquired is a loss, and acquiring more customers faster simply accelerates the destruction of capital.

This problem has been formalised through the Customer Acquisition Cost to Lifetime Value ratio, arguing that a sustainable business requires lifetime value to substantially exceed acquisition cost, typically by a factor of three or more. This is done to account for the time value of money and the cost of serving the customer (Skok, 2010).

Many high-growth startups, particularly in consumer subscription, food delivery, and fintech, have operated with CAC to LTV ratios that are negative: the business loses money on every customer it acquires, and the only path to profitability requires either dramatically reducing acquisition costs or dramatically increasing customer retention and monetisation.

3.2 Subsidised Growth and Market Distortion

A related example is subsidised pricing to increase adoption. Ride-hailing companies, food delivery platforms, and grocery delivery services have all offered prices to consumers that are far below their true cost of service, funded by investor capital. This is done in order to build market share and suppress the growth of competitors. The economic logic is that if you can drive competitors out of the market and raise prices to sustainable levels once you have achieved dominance. The actual dynamics are considerably more complicated.

It is argued that this model of platform competition, funded by venture capital and premised on the elimination of competition before profitability is required, has distorted consumer expectations and market structures in ways that are difficult to reverse (Srnicsek, 2017). When consumers are accustomed to below-cost prices, raising prices to sustainable levels produces significant churn.

When the market structure turns out to be less winner-take-all than the growth thesis assumed, the dominance it was hoped for is not created and the losses are never recovered.

Uber spent over \$20 billion reaching an IPO that valued it below its last private round valuation, and years after listing it was still working toward consistent profitability in its core markets (Kaminsky, 2019). The subsidised growth model created real scale in terms of users and revenue, but it did not create the economic foundation that real scale requires.

3.3 Retention, Churn, and the Leaky Bucket

Even when customer acquisition economics are sound in isolation, growth can be illusory if retention is poor. A company acquiring ten thousand new customers per month while losing eight thousand is growing its user base, but its underlying health of the business is far weaker than the growth number suggests. The marketing and product literature refers to this as the "leaky bucket" problem, which means pouring more water into a bucket with holes will increase the water level, but it is a poor substitute for fixing the holes.

It has been demonstrated that the economics of customer retention are dramatically better than those of customer acquisition (Reichheld and Sasser, 1990). Retaining an existing customer typically costs a fraction of acquiring a new one, and long-term customers tend to generate higher margins, make larger purchases, and refer new customers at higher rates than recently acquired ones.

Companies that prioritise growth metrics over retention metrics are optimising for the wrong thing. In the short term, this produces impressive growth numbers that satisfy investors and press. In the medium term, it produces a customer base that is structurally fragile, a cost structure that is unsustainably dependent on continued acquisition spending, and unit economics that improve far more slowly than the growth narrative implies.

4. Founder Culture and the Psychology of Growth

4.1 The Myth of the Visionary Founder

Modern startup culture is significantly shaped by the myth of the visionary founder who is this exceptional individual seeing the future more clearly than everyone else, executing with superhuman intensity, and building a company that changes the world. This myth is not purely fabricated because there are genuine cases of founders whose vision and execution produced transformative businesses. But, it has been generalised from exceptional cases to a normative framework that shapes how founders are selected, funded, evaluated, and celebrated in ways that have significant costs.

Research on founder dynamics across thousands of startups documents the tension between what he calls rich and king orientations (Noam Wasserman, 2012). This refers to founders who prioritise building financial value as compared to those who prioritise maintaining control and pursuing their vision regardless of commercial constraint.

Neither orientation is inherently superior, but the cultural celebration of visionary founders who don't compromise overweights the second type in ways that produce predictable

governance failures. When founders maintain control through voting structures, board compositions, and force of personality, the normal corrective mechanisms that identify strategic problems are weakened.

The WeWork case again properly illustrates this point. Adam Neumann's control of WeWork through supervoting shares when combined with the board's reluctance to challenge a founder who had produced really great growth metrics, has created conditions in which increasingly hastened strategic and financial decisions went unchallenged until the IPO process forced external scrutiny (Brown, 2021).

4.2 Hustle Culture and Its Hidden Costs

Alongside this, runs a broader cultural framework that appreciates people who have high work intensity, encourages sleeplessness, and fosters the subordination of all other considerations to the growth of the company. This hustle culture is regularly reinforced by the public statements of successful founders, the expectations of venture investors, and the competitive dynamics of talent markets. Here, the willingness to work extreme hours is treated as a signal of genuine commitment.

Hustle culture is connected to wellbeing problems in startup environments, documenting elevated rates of anxiety, depression, and burnout among founders and employees at high-growth startups compared to the broader population (Moss, 2019). The economic costs of these outcomes are not trivial since founder burnout impairs strategic decision-making, high employee turnover in senior roles disrupts institutional knowledge and operational continuity, and the cultural tolerance of overwork creates an environment in which genuine problems are identified and addressed more slowly than they would be in organisations with healthier norms around rest and reflection.

There is also an equity dimension prevailing here. Hustle culture favours individuals without significant caregiving responsibilities, financial safety nets that allow them to work for equity, and the physical health to sustain extreme work intensity for extended periods.

This means that the startup ecosystem's most celebrated cultural norm systematically disadvantages women with children, founders from lower-income backgrounds, and individuals with health conditions, in ways that reaffirm existing social inequalities within an industry that regularly presents itself as a meritocracy (Rivera, 2015).

4.3 The Sunk Cost Trap

A third psychological dynamic that contributes to the illusion of scale is the sunk cost trap. The well-documented tendency for individuals and organisations to continue investing in a failing course of action because of the resources already committed, rather than on the basis of the prospective value of continuing.

In startup contexts, this manifests in founders and investors who continue funding a company that is not working because the alternative is accepting a loss and admitting that the original

thesis was wrong. The sunk cost fallacy across a range of economic and organisational contexts, finding that it is both pervasive and resistant to elimination even when decision-makers are aware of it (Arkes and Blumer,1985).

In venture capital, where the original investment thesis is often tied to the professional reputation of the investors who championed it, the sunk cost dynamic is compounded by reputational incentives. These make it additionally costly to acknowledge failure early. The result is companies that receive additional rounds of funding because the alternative of writing down the investment is professionally and psychologically costly for the people making the decision.

5. Platform Dependency and Structural Fragility

5.1 Building on Borrowed Ground

One of the least discussed risks in the modern startup ecosystem is the degree to which many successful-seeming companies are built on platforms they do not control. App stores, social media algorithms, search engine rankings, and marketplace policies are the distribution channels through which many startups reach their customers. The platform owner's decisions about fees, policy, and algorithmic treatment can affect the startup's business with almost no notice and no recourse.

The fundamental problem is that a startup's investment in a distribution channel that someone else controls is an investment with uncertain property rights. The value created can be partially or entirely compensated by the platform owner through fee increases, algorithm changes, or competitive entry into the startup's product category.

Amazon's history of competing directly with successful third-party sellers on its marketplace, Apple's control of iOS distribution through the App Store and its 30% commission, and Facebook's repeated algorithm changes that reduced organic reach for pages and groups that had built audiences on the platform are all illustrations of this dynamic at scale.

5.2 The Algorithm Dependency Problem

For startups whose growth depends on algorithmic distribution through social media or search, the structural fragility is even more acute than for marketplace businesses. An algorithm change can reduce a company's organic traffic by 50% or more overnight, with no explanation from the platform and no mechanism for appeal. Companies that have built their customer acquisition model around free distribution through algorithmic channels have actually built their revenue on a foundation they do not own.

The competitive dynamics of two-sided platforms and the ways in which platform owners use their control of algorithms and data to favour their own products and preferred partners at the expense of third-party businesses. The DTC brands that built substantial followings on Instagram between 2015 and 2019, riding the platform's algorithmic growth mechanics,

found that their customer acquisition costs increased dramatically as the platform shifted its algorithm toward paid distribution and began competing directly for user attention with its own shopping features. Companies that had been valued on the assumption of continued free distribution were suddenly operating in a fundamentally different competitive environment.

5.3 Regulatory and Policy Risk

Platform dependency is compounded by regulatory uncertainty. This has grown significantly as governments around the world have turned their attention to the market power of large technology platforms. Startups that depend on specific platform relationships, data access, or regulatory frameworks are often exposed to policy changes that can significantly change their competitive environment in unpredictable ways.

The European Union's General Data Protection Regulation, implemented in 2018, significantly altered the economics of digital advertising by restricting the data practices that had made targeted advertising highly effective for startup customer acquisition. For startups whose growth model depended on highly targeted digital acquisition, GDPR was not simply a compliance burden, rather, it was a change to the cost structure of customer acquisition that made some previously viable models significantly less attractive. The broader point is that regulatory and policy risk is an actual risk factor for startups that build their models on platform relationships, data assets, or regulatory frameworks whose stability they cannot control.

6. When Scaling Actually Works

6.1 Network Effects and Genuine Scale Economies

The cases in which rapid scaling produces genuine and durable competitive advantage share a common feature. The network effect is described as one of the most powerful competitive advantages available in technology markets, arguing that businesses with strong network effects tend to converge toward winner-take-all or winner-take-most outcomes in which the leading player's position becomes self-reinforcing (Shapiro and Varian, 1999).

Social networks, payment networks, and marketplace businesses all exhibit network effects to varying degrees. The key question for evaluating whether rapid scaling is economically justified is whether the network effects in a specific business are strong enough and durable enough to produce the competitive moat that the growth strategy assumes.

Many startups claim to be network effect businesses without meeting the structural conditions that genuine network effects require. A delivery app does not have strong network effects: the hundredth customer using the app does not make it meaningfully more valuable to the first.

6.2 Unit Economics and the Path to Profitability

Actual scaling creates economic value when the unit economics of the business improve as it grows. Unit economics refers to the revenue and cost associated with a single customer or transaction, and the question is whether those economics become more favourable as the business scales through fixed cost leverage, improved supplier terms, reduced marginal acquisition costs, or better product quality from accumulated data and experience.

The fundamental discipline of startup scaling is the identification and validation of the unit economics before the company invests in growth (Blank, 2013). A business that has demonstrated that each customer generates significantly more value than it costs to acquire, that customer retention is high enough to accumulate that value over time, and that unit economics improve as the business scales has a rational case for rapid growth. A business that is scaling before these conditions have been established is actually investing in growth. The returns to this kind of growth are speculative rather than demonstrated. The lean startup methodology Blank advocates is really an argument for validating economic fundamentals before committing to scale, rather than assuming that scale will eventually produce the economics the business requires.

6.3 Operational Foundations for Sustainable Scale

Even businesses with sound unit economics and actual competitive advantages can be destroyed by scaling too fast for their operational foundations to support. Rapid growth strains hiring processes, management systems, customer service infrastructure, and organisational culture in ways that can produce a quality collapse precisely when the business is at its most visible. The history of high-growth startups is full of examples of companies that grew their customer base faster than their ability to serve those customers, producing a wave of negative experiences that eroded the trust and reputation on which continued growth depended.

The "doom loop" afflicts companies that grow without operational discipline: the accelerating growth creates operational strain, the operational strain produces quality problems which further produce customer attrition and reputational damage. This damage slows growth, which the company then tries to address by growing faster (Collins, 2001). The disciplined alternative is to scale operational capabilities ahead of or alongside customer growth rather than in its wake, accepting a slower growth trajectory in the short term in exchange for the organisational strength that sustainable scaling requires. The companies that have built durable large-scale businesses, including the exceptional successes that justify the venture model, have generally been characterised by this kind of operational discipline rather than by the growth-at-all-costs approach that the myths of startup culture celebrate.

7. Sustainability, Accountability, and the Future of Startup Culture

7.1 Rethinking Success Metrics

One of the most important changes required to address the illusion of scale is a shift in how startup success is defined and measured, both by investors and a broader culture. The current

dominance of growth metrics, including monthly active users, gross merchandise value, and revenue growth rate, over profitability, capital efficiency, and unit economics creates systematic incentives to optimise for appearance rather than substance. A business that is growing at 100% per year while destroying capital at an accelerating rate is celebrated while a business that is growing at 20% per year with strong unit economics, improving margins, and a path to profitability is treated as unambitious.

Valuation discipline, the rigorous connection of valuations to demonstrated cash flow potential rather than to growth narratives, is the most important corrective available to the venture ecosystem (Damodaran, 2018). When capital is cheap and abundant, this discipline tends to weaken, because there is always another investor willing to fund the growth narrative. When capital becomes scarce and expensive, as happened in 2022 and 2023, the discipline is reimposed by necessity rather than design. The challenge is to institutionalise it as a norm during boom periods rather than waiting for corrections to impose it.

7.2 Alternative Models: Bootstrapping and Sustainable Growth

Not all successful tech businesses have followed the venture-funded hypergrowth model. A significant number of durable, profitable software and technology companies have been built through what is typically called bootstrapping, which means growing on the basis of customer revenue rather than investor capital, accepting slower growth in exchange for control, profitability, and genuine business model validation.

The characteristics of bootstrapped businesses and the constraints imposed by limited capital often produce superior strategic discipline (Bhide, 1992). When you cannot spend your way out of a product problem, you have to solve the product problem. When you cannot acquire customers at a loss indefinitely, you have to build a product that is worth its price. The companies that have followed this model tend to have stronger unit economics, more loyal customer bases, and more resilient business models than their venture-funded counterparts, even if their growth trajectories are less dramatic. Basecamp, Mailchimp before its acquisition, and Notion in its early stages are all examples of businesses that built scale without excessive venture funding.

7.3 Accountability Structures and the Role of Governance

Reforms most likely to reduce the frequency and cost of the illusion of scale are those that strengthen accountability mechanisms within startup companies and the venture ecosystem. Strong independent boards, transparent financial reporting, and incentive structures that align founder and investor rewards with long-term business health rather than short-term valuation maximisation would all reduce the conditions under which the illusion of scale is created and sustained.

The classic case for board independence as a mechanism for reducing agency costs are the costs that arise when the people making decisions for an organisation, founders and management teams, have interests that diverge from those of the people who own it (Fama

and Jensen, 1983). In the startup context, the relevant agency costs are those that arise from founder incentives to pursue growth at the expense of unit economics, from investor incentives to mark up portfolios regardless of operational progress, and from the mutual incentive of both parties to present positive narratives to the market regardless of underlying fundamentals.

Governance structures that introduce independent oversight create friction that slows the most damaging expressions of them. The reforms are not complicated, they are the basic elements of corporate governance that established public companies are required to maintain, applied to earlier-stage companies whose decisions are equally consequential.

8. Conclusion

The illusion of scale is not a peripheral phenomenon in the modern startup ecosystem. It is close to the central dynamic, produced by the intersection of a venture capital model that rewards growth over sustainability, a cultural framework that celebrates the myth of the visionary founder, a funding environment that has, for extended periods, made capital so cheap that its misallocation carried minimal cost, and a metrics culture that systematically elevates appearance over substance.

This paper has argued that the mechanisms through which the illusion is created and sustained are well understood and, theoretically, addressable. The venture capital model's power law logic creates systematic pressure for high-risk, high-growth strategies regardless of business fundamentals. Artificial growth through customer acquisition spending creates the appearance of scale while destroying the economic foundations that genuine scale requires.

Founder myth weakens governance and creates conditions in which strategic failures are identified and corrected more slowly than they would be in better-governed organisations. Platform dependency creates structural fragility that is invisible during growth phases and catastrophic during corrections. The dominant metrics culture rewards the wrong things, creating incentives that are misaligned with the creation of durable economic value.

Genuine scaling, in the cases where it produces real value, works because the underlying business has network effects strong enough to justify rapid investment in growth, unit economics that improve with scale, and operational foundations capable of sustaining the quality of product and service that customers require.

These conditions are less common than the funding volume and cultural celebration of growth would suggest. The startups that meet them deserve the capital, the attention, and the celebration that the ecosystem provides. The ones that do not are perhaps best understood as a very expensive lesson in the difference between the appearance of building something and the substance of it.

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